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# SOME REFLECTIONS ON THE "NEW SCHEME FOR MONETARY CONTROL" BY THE BANK OF JAPAN

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# SOME REFLECTIONS ON THE "NEW SCHEME FOR MONETARY CONTROL" BY THE BANK OF JAPAN

*By* Tsuneo ISHIKAWA\*

## Causes and Adverse Effects of Overloan

### Introduction

In October, 1962, the Bank of Japan decided to adopt the "new scheme for monetary control" to regulate supply of credit in lieu of the conventional system depending on loans provided by the Bank of Japan. The new scheme consisted of buying and selling operations of securities and setting ceiling limit of loans by the Bank of Japan.

According to the statement of the Policy Board at that time of the Bank, it "intends to utilize flexible buying and selling of securities as a key means of monetary control". The Bank of Japan "wants to correct the current situation where financial institutions depended too heavily on loans from the Bank, and further, to promote adequate and harmonious development of finance". Therefore, the Bank "hopes that borrowings of the commercial banks provided by the Central Bank will not exceed the current limit—indeed, it will exercise strict control over certain limited number of commercial banks who actually depend unreasonably on such loans". (Ref. 2, pp. 7)

In other words, the Bank of Japan was anxious to apply a brake on the galloping overloan situation that followed the record boom period from 1959 to 1960, which resulted very quickly in deterioration of loan to deposit ratio of commercial banks who borrowed heavily from the Bank of Japan. The aim was to make those banks—major city banks in particular—more conscious of their liquidity positions so as they would be compelled to exercise self-control on their own initiative. With such an objective in mind, BOJ decided to make use of the buying and selling operations of securities as the key means of controlling money supply. Loans would be extended, but they were to have only the secondary importance. Thus, BOJ thought, would enable it to conduct the control in a much more subtle and multifarious ways while establishing the Bank's initiative in the matter of credit control. Thus, the lending limit was set at 1,240 billion yen towards ten city banks whose liquidity positions

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were particularly unfavorable then. Beyond that limit, these banks were to pay an extra penalty interest of 3.65 percent. This was almost equal to prohibit their borrowings above the ceiling.

#### Causes of Excess Lending by Commercial Banks

Let us consider why the overloan happened and why they were more than undesirable. In general, there are four channels through which funds—cash—is poured into the national economy. They are: deficit in Treasury General Account with the Public, deficit in the Foreign Exchange Special Account, i.e. surplus of the balance of payment, loans made by Bank of Japan, and finally, buying operation of securities by BOJ.

Table 1 shows how each of these channels worked to increase supply of cash currency during thirteen years from 1960 to 1972. First of all, for the period of 1960–62, with regard to the Treasury Funds, both the General Accounts (including the Foodstuff Control Special Account) and the Foreign Exchange Special Account recorded basically surplus. This was not surprising, since during any period of high growth, revenue of income tax increases sharply and funds go back to the Treasury Account. In case of Japan, Treasury Funds are not allowed to be placed in trust deposit at commercial banks, hence revenue in excess of disbursement immediately reduces funds held by financial institutions. Therefore, any demand for credit must be met by increasing loans from BOJ. During the period in question, for instance, such loans rose sharply—by 686 billion yen alone in 1961. In other words, although the lending competition among commercial banks was the fundamental cause of overloan, it should be noted the large surplus in Treasury Account was another facet of the causes. (Ref. Table 2)

As for the adverse effect of the overloan, the Bank of Japan was concerned lest the overloan—if it were to continue for an extended time—should spoil the commercial banks, because they would come to take it for granted and assume an unreasonably lax attitude towards their liquidity position. This would be particularly so because the official discount rate had been kept always below the average interest rate charged by commercial banks. On the other hand, the city banks were competing with each other in order to expand their respective “shares” by pumping money into industry without too much discretion. An end result would be overheating of economy and a large deficit in the balance of payment.

However, if buying and selling operations of securities were used as a means to regulate money supply, it would mean that a part of the financial assets accumulated as a result of economic growth (such as public and corporate bonds) would gradually move from the commercial banks to the Bank of Japan who in turn would supply money to them. Unlike the loans, there will be an effective brake in such a system because the money supply could not go beyond the total volume of the eligible securities held by the commercial banks.

It also means that the commercial banks are required to use their judgement in composing their own financial assets, which include bonds eligible for buying by BOJ, and to check carefully their liquidity position before extending loans and credit to avid borrowers. For instance, if credit is supplied from BOJ on the basis of buying operation, the commercial banks would refrain from lending to the last limit because they would prefer to keep those eligible securities. If this system operates successfully to improve liquidity position of the commercial banks, they in turn will become much more conscientious in maintaining a sound position by themselves. In that event, there will be an autonomous, self-imposed discipline at work, and it would no longer be necessary to have recourse to those direct control such as "window guidance" which, if effective, is not, after all, a very elegant method to be used by the Bank of Japan.

### **Buying and Selling Operations as a Means of Credit Control**

Loans and buying operations are same in the sense that they are both to provide credit to commercial banks by BOJ, although there is a significant difference as to where the initiative rests. Loans are made possible only because borrowers are eager to get money, so it may be said, *grosso modo*, that borrowers have the first initiative (we say *grosso modo* because under certain circumstances, BOJ may direct borrowers to turn to the call money market). Contrarily, in the case of buying operations, the initiative clearly lies in the central bank. A loan, once extended, cannot be retired until the maturity of its term, regardless of the surrounding circumstances, whereas the central bank can always withdraw a credit by selling operation. This system not only gives the BOJ a valuable initiative; it enables the Bank to intervene much more actively and flexibly.

It is well known that this type of monetary control is called open market operations in the United States and in the United Kingdom. In these countries, financial market is fully developed and direct financing by means of a variety of bonds and debentures is carried out in the market. The central banks, therefore, can act as if they were investors coming to an open market and still exercise effective control through the established market mechanism. Both in U.K. and U.S.A., a large volume of wartime bonds were dumped into the market soon after the World War II, and the authorities were obliged to support the prices by massive buying out of the market. However, as the inflationary trends were gaining the momentum towards 1950, buying stopped, and the bonds were again resold to the market (this was the so-called "revival of the monetary policy"). There-after, the open-market operations became one of the most important means to control credit supply.

Unfortunately, conditions of the postwar finance in Japan did not allow the Bank of Japan to utilize such a method. For one thing, the hyper inflation had reduced the value of prewar bonds to almost nil, and on the other hand, the govern-

ment did not issue any long-term bonds until 1965 in order to maintain balanced budget. Interest rate was kept intentionally at a low level to accelerate the economic growth. All told, therefore, the bonds market was far from mature, or rather, open market simply did not exist. The Bank of Japan made a timid start by introducing so-called "one-to-one buying and selling operations" which means buying and selling of public bonds guaranteed by the government with a repurchase clause to city and local banks, trust banks and the long-term credit banks. Although this was a significant step forward, it was by no means full-fledged market operations, because BOJ dealt with individual banks directly. In absence of the developed market like those in U.S.A. and U.K., the Bank of Japan had to develop the market at first in order to make bond operations possible.

#### Brief History of Bond Operations in Japan

Ten years have passed since the start of the new system, and it would be appropriate to review briefly how the system has worked so far.

It should be noted that even before the start of the new system, the Bank of Japan did conduct occasionally buying operations of government-guaranteed public bonds. Its purpose, however, was to ease off shortage of funds caused by seasonal surplus of Treasury Accounts. Interest rates were fixed without any bearing on prevailing market rates, and as mentioned previously, deals were made directly between the buying BOJ and a seller bank.

When the new system was initiated in November, 1962, the Bank of Japan lowered the buying rate to the same level as that of yield to a subscriber of the government-guaranteed bonds. Concurrently, the official discount rate was reduced in two steps, in October and November of that year. This made it possible for the commercial banks to obtain supply of funds at then prevailing rate by selling the eligible bonds to BOJ (who attached the repurchase clause). Although it resembled only very remotely to the open-market operations, the system was nevertheless tide into the market in a large sense in that interest rate was no longer fixed.

Already towards the end of Fiscal Year 1962, however, volume of the eligible (government-guaranteed) bonds held by the commercial banks fell quickly. According to the statistics, amount of bonds held by the commercial banks as of the end of that year was 240 billion yen. In the case of previous operations, buying was conducted with the repurchase clause, so holdings of the eligible bonds by commercial banks never depleted completely. As BOJ increased number of operations and their flexibility, however, individual operation gained in size and reached 70 to 100 billion yen, and it was natural that the volume of bonds in stock became insufficient.

Consequently, the Bank added in January, 1963 to the list of the eligible bonds the following items: government bonds (40 billion yen), debentures issued by electric power companies (200 billion yen), interest bearing bank debentures (400 billion yen), and eligible local government bonds (80 billion yen). This added 720 billion

Table 1. Supply of Funds  
FY 1960~1972

unit=100 million Yen

fiscal year	bank notes issued	total	Treasury Accounts				others	reserve deposit	total	loans	Bank of Japan credit					
			(A)	(B)	(C)	(D)					(A)	(B)	(C)	(D)	(E)	(F)
1960	2,003	51	-2,659	323	2,387	—	181	73	2,206	2,205	1	—	—	—	—	—
1961	2,171	-4,909	-2,725	25	-2,209	—	543	602	8,225	6,860	1,365	—	—	—	—	—
1962	2,343	2,033	118	538	1,613	—	719	286	743	122	621	—	—	—	—	—
1963	2,465	614	580	69	35	—	238	1,233	3,322	-1,520	4,842	—	—	—	—	—
1964	2,475	4,394	2,960	1,379	55	—	1,654	552	817	1,346	-2,163	—	—	—	—	—
1965	2,580	2,662	2,073	1,609	65	-1,085	275	927	1,120	2,975	-1,855	—	—	—	—	—
1966	3,635	-2,220	2,218	2,615	397	-6,656	-1,443	597	6,701	930	5,624	—	—	147	—	—
1967	4,618	752	484	5,235	655	-5,816	-1,527	893	7,790	-1,371	8,850	—	—	311	—	—
1968	5,306	3,478	-1,763	5,477	4,434	-4,670	-2,536	272	4,092	169	4,098	—	—	163	—	—
1969	6,895	1,312	-3,481	4,333	4,286	-3,826	-2,362	-1,855	9,800	4,269	4,526	908	—	97	—	—
1970	6,490	-1,447	-7,077	2,047	6,755	-3,172	-2,960	567	11,464	4,385	8,102	1,525	-3,000	452	—	—
1971	7,114	30,282	-3,771	331	43,556	-9,172	-1,261	227	-21,680	-17,780	-1,501	-2,433	3,000	-966	-2,000	—
1972	15,350	474	-2,184	1,690	17,870	-16,902	788	-6,412	20,499	10,795	135	—	—	115	2,000	7,953

(A) General

(B) Food Stuff

(C) Foreign Exchange

(D) long-term bonds

(A) bond operations

(B) short-term operations of corporate bonds

(C) short-term government securities operations

(D) foreign exchange bills operations

(E) selling of bills issued by BOJ

(F) buying of commercial bills

note: "others" means deposits at BOJ agencies, repayment of short-term bonds, auxiliary currencies, etc.

source: Economic Statistics, Bank of Japan "Monthly Report of Public and Corporation Bonds", Japan Development Bank.

yen to the volume of securities available for buying operation by BOJ. In addition, the term of repurchase was extended from three months to one year, opening the way to outright purchase operation. In March, 1963, BOJ exercised the first buying operation for the electric debentures and bank debentures, and by the end of that fiscal year, there was 484.2 billion yen buying in excess. (Ref. Table 1)

In May, 1964, the scope of the banks eligible for the operation was further enlarged to include fifty-one mutual loan and saving banks and twenty credit associations. This means that even these financial institutions for smaller business firms were now able to obtain credit by BOJ's buying operations. In the meantime, the official discount rate was raised in March, 1964, and during Fiscal Year 1964, the balance of bond operations registered selling in excess of 216.3 billion yen. In our opinion, this bears witness to the fact that the bond operations were not only a valid means of ensuring growth of credit supply to replace to BOJ loans, but they were also a very effective means of monetary control. The Japanese economy calmed down in 1965 and money supply was relaxed (for example, the official discount rate was reduced three times in succession in January, April and June that year), while demands for funds also decreased considerably. Thus, the balance of operations during Fiscal Year 1965 showed the sales excess of 185.5 billion yen (Table 1). In July, 1965, a major obstacle to successful implementation of buying operations occurred as a result of the drastic reduction of the official discount rate. Since the interest rate applicable to buying operation was linked to the yield to bond subscribers, it stayed above the interest rate of BOJ loans. For the commercial banks, it was therefore more advantageous to borrow from the Bank. Under these circumstances, the Bank of Japan was compelled to suspend for a time being all buying operations, and for this reason, the balance of bond operations ended with excess sales as indicated earlier despite the fact that money supply was increased throughout the fiscal year. On the other hand, loans from BOJ increased to 297.5 billion yen (Table 1).

During the last quarter of that fiscal year (January to March, 1966), a number of situations previously unknown to the bond operations occurred. First of all, the government issued the much debated 6.5 % long-term bonds (although they were not immediately eligible for buying operation, because one year must go before BOJ could trade long-term government bonds under the law). Also, during the same month, the Bank of Japan started operations for the short-term government bonds with regard to short-term credit brokers (it followed the start of BOJ loans to those brokers in December, 1965). This was a measure of ensuring adequate money supply to the call market with a view to stabilize call money rates and to exercise a flexible control of credit by active trading of the government short-term bonds in the call money market.

This short-term bond operation was subject to repurchase within three months. Since the start, however, until the end of 1971, trading was very brisk and buying and selling continued at the pace of 200 to 300 billion yen for each ten-day period (these



transactions, however, do not appear in Table 1, which is based on each fiscal year). It means that for the first time after the last War, there was established a clear division between the bond operation destined for money supply for economic growth and short-term government securities operation through call money market to regulate short-term money supply. Furthermore, as the public and corporate bonds market was reopened in February, 1966, Bank of Japan started to conduct outright purchase of bonds at market price in addition to the conventional buying with the repurchase clause. Thus, Japan's bonds operations made a farther stride ahead towards a real open market operations.

#### Buying Operations of Long-Term Government Bonds

Towards the end of Fiscal Year 1966, there occurred again a shortage of government guaranteed bonds eligible for buying operation by BOJ. The Bank lost no time to start buying of the long-time government bonds issued a year ago, and also during the same month, i.e., February, 1967, it made outright purchases of certain government-guaranteed bonds and interest bearing bank debentures. Operation of foreign exchange bills also started at that time, but the amount was insignificant (under one billion yen per month) and was subsequently abolished in June, 1972 when operations of commercial bills were started. During the fiscal year 1966, there was an excess buying balance of 562.4 billion yen. Major items were the outright purchase of government-guaranteed bonds and buying of the newly issued 6.5 % long-term government bonds (Table 1).

As this time, it must be remembered that issuance of government bonds per se means withdrawal of treasury funds. It contributes to promote inflation only because the funds obtained by the issuance are actually spent to boost effective demand by multiplier effect. Issuance of government bonds in itself deflates the money supply. During the years that followed 1966, the government issued long-term bonds at the amount of several hundreds of billion yen per year, resulting in massive withdrawal of treasury funds, while on the other hand large disbursement resulted from the Food-stuff Control Special Account (reflecting a sharp increase in administered rice price for producers) during the fiscal years of 1967 to 1969, and from the Foreign Exchange Control Special Account (due to sudden increase in surplus of the balance of payment) since the fiscal year of 1968. However, the Treasury General Account basically recorded surplus, except for the fiscal year of 1968 which showed excess disbursement of 347.8 billion yen, equilibrium was maintained between the revenues and disbursements throughout the period. Contrarily, during fiscal years 1967 and 1968, bond operations registered excess buying of 885 billion yen and 409.8 billion yen respectively, of which outright purchase of government-guaranteed bonds and long-term government bonds were the major factors. The balance of BOJ loans declined continuously in the meantime.

In June, 1969, the Bank of Japan started a new type of short-term buying ope-

ration of bonds which is called seasonal operations. This was buying of government bonds, government-guaranteed bonds and interest bearing bank debentures with a repurchase clause of one month, and buying price was based on market price and interest on call rate, respectively. Bank debentures had been removed from the eligible list since the start of buying of government bonds, but they were again included as an instrument of buying operations. The new short-term buying operations were introduced as a complementary measures of seasonal control for which the Bank of Japan had already been buying and selling short term government securities and controlling BOJ loans. Since June, 1969, this type of buying operations continued at the rate of several tens of billion yen per month, and since around November, 1969, it came to be utilized particularly as a means of supplying yen funds to the foreign exchange market (so-called "yen shift", i.e., utilization of usance in Japanese yen rather than in foreign currency).

The Bank of Japan discontinued this type of short-term operation in August, 1971 when the BOJ started selling operations of bills issued by the Bank. During the fiscal years of 1969 to 1970, both the Foodstuff Control Special Account and Foreign Exchange Control Special Account recorded large excess disbursements of several hundreds of billion yen, but the Treasury General Account had a large surplus. For this reason, the Bank of Japan was compelled to supply, during the fiscal year of 1969, 553.1 billion yen by means of bond operations and 426.9 billion yen by loans. In the following year, the buying operations totaled 707.9 billion yen and loans came up to 438.5 billion yen, respectively (Table 1).

### **Debut of Operations of Commercial Bills**

The buying operations of the Bank of Japan during the fiscal year of 1970 gained in size and 810 billion yen was spent alone in unconditional buying of government bonds and other government-guaranteed bonds. There are two major reasons for such an enormous buying. Firstly, the Treasury withdraw 707.7 billion yen as tax revenues in excess of disbursements, and secondly two years' consecutive high growth of the Japanese economy (18.8% in 1969 and 16.2% in 1970) boosted demand for money supply by leaps and bounds. Already in the fall of 1970, BOJ was concerned over the possible shortage of eligible bonds for buying operations during the next fiscal year, and this led to a decision to study the feasibility of commercial bills operation from November, 1970.

In this connection, there are a few questions of fundamental importance. If, for instance, buying operation is limited to those bills eligible for rediscount only, will there be any difference between buying operations and loans on rediscount basis? An answer to this, as we discussed previously, is the fact that loans cannot be extended unless borrowers request them, while operations can be carried out by unilateral initiative of BOJ. The second problem was if operations were to be extended

to commercial bills, how to set the interest rates applicable to such operations in the absence of the market. Should the interest rate be equal to the official discount rate, which is always below the prevailing interest rates, buying operations under such circumstances would amount to continuation of overloan, even if there is a measure of one-sided initiative on the part of the Bank of Japan. Buying and selling of commercial bills can be considered a legitimate step towards the real open market operation only when their prices are somehow tied to "market prices". Such operations should not be regarded as a makeshift solution to the shortage of eligible securities. They presuppose existence of effective market of commercial bills, and if it does not yet exist, it must be created and developed.

#### Creation of Commercial Bills Market

Under these circumstances, short term credit brokers, upon request of the Bank of Japan, agreed to consult with the city banks with a view to establish a commercial bills market. According to the preliminary plan drawn up by those brokers, the new market will (1) deal with those call money funds whose term is 60 days or more, (2) the interest rate to be quoted for the 60 day term will be 0.125 % above the rate for call money in over-month end, although this will be used as the center rate and the actual rates will be quoted flexibly within the range of 0.25 % above and below that center rate, and (3) the bills to be traded will be limited to those eligible papers issued by qualified corporations (Nihon Keizai Shinbun, April 19, 1971).

Originally, establishment of the commercial bill market was contemplated with a view to form a kind of "price/interest quoting market" only, consistent with the BOJ plan to start buying and selling operation of commercial bills (ibid). However, Japan's international balance of payment started to register large amounts of surplus every month from the beginning of 1971, which led to expansion of disbursements from the Foreign Exchange Control Special Account. While only several months ago, funds were short and there were not enough eligible securities for BOJ to buy, by the end of May, 1971, the situation was completely reversed and the authorities were worried about excess liquidity. The Bank of Japan therefore expected to postpone start of buying commercial bills until the beginning of 1972. The short term credit brokers nevertheless decided to open the commercial bill market on their own initiative as a step to prepare themselves for the operation of commercial bills in future.

In reality, there was such a large excess liquidity as already mentioned, and the Bank of Japan felt it necessary to sell BOJ bills and other commercial papers in its possession towards the end of May, 1971. It was ironical that the original scheme of developing a commercial bill market in order to supply much needed funds by buying operations had to be reversed within several months and now the short term brokers opened the market on their own initiative, while excess liquidity had to be absorbed by selling operations of the Bank of Japan.

### Operation of Commercial Bills Developed as a Means of Seasonal Adjustment

Satisfied with the steady growth of the new commercial bill market since its opening in May, the Bank of Japan started to sell BOJ bills in August, 1971. In June, 1972, the Bank finally undertook to buy commercial bills in order to ease off the seasonal shortage of funds. Thus commercial bill operation became finally a regular method of monetary control based on market mechanism rather than on one-to-one matching deal, and operations of foreign exchange bills were absorbed within the commercial bill operation.

The fiscal year of 1971 (which saw the first upward revaluation of yen) was remarkable in that Treasury Funds registered a spectacular excess disbursement of 3,000 billion yen as a result of outflow from the Foreign Exchange Control Account of 4,355.6 billion yen. This caused the BOJ credit to shrink, as repayment of loans to the Bank of Japan reached 1,778 billion yen, and overloan to commercial banks virtually disappeared. BOJ's security operation recorded, for the first time since 1965, selling in excess of 390 billion yen (total of bonds and bills).

During the next fiscal year of 1972, large deficit of Foreign Exchange Control Account continued, and combined with the easy monetary policy, quantity-theory type price increase gained intensity towards the latter part of the year. New issue of bank notes reached 1,535 billion yen, a two-fold growth over the previous year. Since Treasury revenues and disbursements maintained equilibrium throughout that year, the Bank of Japan compelled to expand credit by 2,000 billion, of which 1,079.5 billion was supplied by loans to commercial banks and 970.3 billion by buying of commercial bills and other securities.

Commercial bill operation of BOJ (started, as previously referred to, in June 1972 when the Bank started to buy) became very active in 1973. Monthly amount of trading has reached several hundreds of billion yen. It now functions as a major means of seasonal, short-term monetary control, replacing the conventional buying and selling of short-term government securities with the short-term credit brokers. In the sense that bills are traded by BOJ at the market rather than with individual financial institutions as partners, it is considered to be a significant progress of operation towards a fullscale open market operation.

### Some Problems Associated with the New Scheme for Monetary Control

In retrospect, there are two noteworthy aspects in the history of BOJ operations in bonds and bills. Firstly, the Bank expanded very quickly the scope of financial institutions eligible as partners in the operations at the initial phase. On the other hand, kinds of the instruments for buying and selling also increased quickly, with occasional exclusions of a few kinds. If the buying and selling operations are to constitute the most important means of monetary control for growth instead of loans from BOJ, it is quite natural that such expansions should take place in due course.

However, a question arises as to the criteria of eligible securities since there, discretion of the policy body—the Bank of Japan—comes into play. For instance, certain bonds are directly related to key industries. If debentures issued by electric power companies are selected as the object of buying operations, the Bank of Japan is actually going to supply funds to the electric power companies. Another example is the local government bonds, most of which are purchased by local banks. As the Bank of Japan increases buying of these bonds, more money will flow into the local banks rather than to other commercial banks.

Clearly, there is a danger of distortion in money supply depending on the choice of securities for BOJ operation. This could be an advantage, since it makes possible for BOJ to exercise a selective control with direct influence on key industries or major sector of the national economy. In other words, one-to-one matching operations leave the Central Bank various choices of eligible securities or financial institutions, which enables BOJ to control money supply selectively, if not arbitrarily. On the other hand, BOJ might be interested only in controlling money supply in general; yet its effect could be selective or arbitrary, depending on the choice of instruments. Therefore, it should be kept in mind that operations of securities have a character of double-edged sword. In order for the buying and selling operations to become a general means of monetary control without any odds and twists, they must orient themselves to open market which still remains to be brought into existence at this time.

#### Prerequisite for Existence of Open Market

What, then, will be the prerequisite conditions for such an open market to exist? If we consider the case of commercial bill market established in May, 1971, it can be said that opening of the market induced the lenders of call money with a relatively longer term to meet the demand for such money in the market. Already at that time, there was a tendency for call loans to go beyond end of month. Also, the fact that rates were quoted flexibly within plus and minus 0.25 % around the center rate, which is 0.125 % above the call rate, can be considered as a positive factor for development of the market. One conclusion we can draw from our experience would be that such a market can exist where demand and supply are both relatively stable (i.e., they do not fluctuate too much within a short period of time) and there is a room for quotation to move with flexibility around the reasonable level.

The new commercial bill market satisfied all of these requirements. In case of public and corporation bonds market, yield to subscribers was always pegged to a low level because of low interest rate policy and this has prevented the market from becoming mature enough for open market operations. Although the public and corporation bonds market was reopened in February, 1966 and the Bank of Japan immediately started to make outright purchase at market prices, it was not a real

market in the sense that it only acted as price/interest quoting market and one-to-one transactions continued between BOJ and individual financial institutions on the basis of such prices and quotations. This still is the case. There is little question that price mechanism must be made to work in the public and corporation bonds market if it is ready for real operations. This requires liberalization or decontrol of interest rates. The fact that interest rates are steadily going up in most of the international money markets seems to provide a good opportunity to introduce such a decontrol in Japan. Domestically, however, this will involve a number of tough problems such as drastic increase of financial costs, need to change the taxation system with a view to encourage direct financing of corporations, need to make buying and selling of public and corporation bonds more accessible to the general public, and some other issues of vital importance to the finance.

#### How Far the Objectives Have Been Met

Finally, let us review how far and well various targets have been met by the new scheme since its appearance in the Japanese monetary control measures. The Bank of Japan indeed published set of targets prior to the start of operation in 1962.

First of all, we should take up overloan picture. According to Table 2, it is evident that there has been a considerable improvement, particularly in the recent past, compared with 1961 which was the worst year. The Bank of Japan borrowing ratio, i.e., the relationships between BOJ and city banks, has achieved a remarkable improvement. Contrary to the BOJ vs. city banks relationships, improvements are less conspicuous between city banks and business corporations (as indicated by the outside debt ratio). As we can see from the table, every index shows a drastic improvement during 1971, but this owes to excess disbursement from the Foreign Exchange Control Special Account. It does not mean any significant development in bonds and bills operation. Credit by BOJ actually decreased during that year.

Table 2. Overloan Index of City Banks

F/Y	60	61	62	63	64	65	66	67	68	69	70	71	72
lending ratio	98	103	105	102	104	99	97	99	96	97	99	93	93
outside debt ratio	14	22	22	19	21	19	17	16	15	16	18	8	8
BOJ borrowing ratio	8	18	16	12	9	9	10	8	8	8	9	2	5

note :

$$\text{lending ratio} = \frac{\text{lending}}{\text{net deposit} + \text{bonds issued}} \times 100$$

$$\text{outside debt ratio} = \frac{\text{borrowing} + \text{call money} - \text{call loan}}{\text{net deposit} + \text{bonds issued} + \text{borrowing} + \text{call money} - \text{call loan}} \times 100$$

$$\text{Bank of Japan borrowing ratio} = \frac{\text{borrowing from BOJ}}{\text{net deposit} + \text{bonds issued} + \text{BOJ borrowing}} \times 100$$

(source : Economic Statistic Annual, Bank of Japan)

Another question to be asked would be this: has there been any significant

change in the attitude of commercial bank—particularly city banks—since the start of the new system? Are they more conscious of their liquidity position, and do they show any self-imposed discipline in making lending decisions? The outside debt figures shown in Table 2 indicates a modest improvement from 1965, and since 1971, there occurred a rapid improvement reflecting deficit in the Foreign Exchange Control Special Account as well as the easy monetary policy during that period. City banks, however, do not appear to have tried to maintain sound liquidity position by taking the advantage of this sudden increase of money supply. They started towards the middle of 1972 keen competition to lend their excess funds to all borrowers, including those intermediate firms who had remained alien to the city banks until then, to such an extent that the share held by the mutual loan and saving banks and credit associations who had been the primary sources of funds to those intermediate firms actually dropped temporarily. Thus the outside debt ratio of city banks started to deteriorate again during the latter half of 1972.

It would seem, therefore, that the Japanese city banks are more sensitive to profit motive than to liquidity motive. As said earlier, even when money was readily available, as was the case of 1971 and 1972, they showed little willingness to increase their liquidity by decreasing their outside debt ratio. This inherent attitude of the city banks has drove the Bank of Japan to exercise so-called "position guidance", which is nothing but another form of once-abolished window guidance, whenever it wishes to tighten money supply.

The fact that the Bank of Japan always tried to make the most of buying and selling operations and to expand them further since their start cannot be questioned. There have been some remarkable achievements accomplished, opening the way to a real open market operation. Nevertheless, there remains much to be done. For one thing, the Bank of Japan should not be content with ensuring supply of funds required for consistent long-term growth of Japanese economy. It must utilize the operations as a means of short-term or seasonal control, and possibly, to stabilize fluctuations of Treasury Account balances. The Bank is expected to assume the dual role with flexibility and decisiveness.

That the difficult problems of overloan can be dealt with effectively, if not entirely, can be seen from what happened in 1971. Still, the Bank of Japan is obliged to maintain its position guidance so long as the commercial banks are not duly conscious of their liquidity position, a fact which owes to the inherent characteristics of the Japanese finance structure.

Although the commercial bill operations are conducted towards a particular sector of financial markets, they nevertheless meet the basic requirements for open market operation. In the case of bond operations however, there are a number of problems whose solution will undoubtedly require many years to come before they could attain the maturity, because development of the market needs more than the initiative of the monetary authorities.

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